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Are Small Banks Beautiful in Indonesia?

By Thomas Timberg, Partnership for Economic Growth (PEG)[1]
February 2002

"The overriding public policy concern regarding [small business lending] is not the quantity of small business lending, but rather economic efficiency. If some banks are issuing loans to finance negative net present value projects, then such loans should be discouraged. If consolidation of the banking industry or the increased complexity of financial services firms reduces such lending, then economic efficiency is promoted by freeing up those resources to be invested elsewhere, even though the supply of small business credit…is reduced…If modernization increases the supply of loans to creditworthy small business borrowers to pursue financially sound projects, then economic efficiency is also raised as the supply of credit to these small businesses rises."

Remarks by Governor Laurence H. Meyer, May 23, 1997 from http://www.federalreserve/gpv/boarddocs/speeches/1997/19970523.htm.

There is an impression afoot that what Indonesia needs is the euthanasia, mercy killing, of small banks because they are too small and irresponsible to be entrusted with the public's money. Actually, small banks including Bank Perkreditan Rakyat have performed relatively well during the banking crisis, are performing even better now (at least those who are active), and are actively funding various key sectors of the economy. Further, not only are existing small banks performing well, but especially for rural banks many new entrants are waiting in the wings -- willing to risk considerable sums of their own capital and undergo a laborious and somewhat complex licensing process in order to enter the banking industry.

Small Banks Are Prospering and Expanding -- The Market Loves Them

Of the banks operating in Indonesia in 1999 roughly 70 small ones had Capital Adequacy Rations of over 4% and were permitted to continue operating as such. The remainder were either closed or supported in recapitalization. These 70 banks are contrasted to the 11 so called IBRA (Indonesian Bank Restructuring Agency) banks, which are mostly owned by the government and are being recapitalized, the six state banks, the provincial development banks, and Bank Perkreditan Rakyat (BPR -- without access to the payments system). Class A banks now account for perhaps 7% of total lending versus roughly 24% for foreign banks, 44% for the State Banks, and 4% for Provincial Development Banks.[2]

The October 2001 issue of *Infobank,* a trade journal, was devoted to these small banks. It particularly looked at the 77 banks with assets of under one trillion rps or less as of June 30, 2001. These include 14 Provincial Development Banks, and at least 10 foreign/mixed banks, as well as one State Bank (Bank Shariah Mandiri, actually a subsidiary of the giant Bank

[1] PEG is a United States Agency for International Development (USAID)-funded Project with the Government of Indonesia. The views expressed in this report are those of the authors and not necessarily those of USAID, the U.S. Government or the Government of Indonesia.
[2] Bank Indonesia, *Annual Reports, Infokom.*

Mandiri). But the group is dominated by small private banks. These 77 small banks had 3.8% of all assets, 3.15% of deposits, and 5.20% of loans. Their return on assets was .76% and on equity 5.54%. The return on assets for the banking system as a whole was .52%, for Class A Banks .70%, but it was much higher for the Provincial Development and Foreign/Mixed Banks.[3] Forty percent of these 77 banks showed a profit. For reference, the top ten Class A Banks which have more than one trillion of assets -- Mega, Buana, NISP, CIC, Panin, Maspion, Mestika, NHP, Bank Dagang Bali, and Bank Muamalat Indonesia. Of these NISP (Bandung), Maspion (Surabaya), NHP (Bandung), Bank Dagang Bali (Denpasar), and Mestika (Medan), are among the 20 private banks with headquarters outside of Jakarta, which are noted in the same issue as especial sources for small business lending.[4]

The situation of the 2500 odd BPR, which accept deposits and make loans, but do not offer current accounts is more complex. A considerable number were in trouble long before the crisis of 1997. These are now being closed or merged, and the remainder are profitable and expanding rapidly. See Table I below. There are roughly 20 applications already with Bank Indonesia, the central bank, for new licenses -- but more will be forthcoming as soon as new licenses are granted.

Table I

Progress of Banks Perkreditan Rakyat (BPR) in Billions of Rps

Quarter	Qtr II 2000	Qtr III 2000	Qtr IV 2000	Qtr I 2001	Qtr II 2001
Assets	4370	4623	4986	5192	5588
Credit	3214	3410	3776	3947	4223
Public Deposits	2456	2854	3094	3254	3659

SOURCE: *Laporan Trivulanan III 2001*, p. 92.

Comparison of New BPR with Commercial Bank Credit

Quarter	Qtr I 2001	Qtr II 2001
Assets in Trillion Rps	1087	1076
Credit in Trillion Rps	340	365
Public Deposits in Trillion Rps	730	753
BPR Assets as Percentage of Commercial Bank Credit	.47	.52
BPR Credit in Percentage of Commercial Bank Credit	1.13	1.16
BPR Public Funds as Percentage	.45	.49

SOURCE: *Laporan Trivulanan III 2001*, p. 83.

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[3] *Laporan Trivulanan III 2001*, p. 90.

[4] Kristopo, "Serbuan Kredit Bank Swasta Daerah," Infobank 33, October 2001.

Banking Landscape – What Will Happen: Small Banks Have A Great Scope

It is still difficult to envision what banking structure will emerge in Indonesia in the next decade. This structure will depend both on policy decisions and market forces. A second banking crisis for which budget resources are lacking – would have a dramatic impact, for example.

Tendencies

However, certain tendencies are apparent. Some of these have to do with the demand side of the loan market. Retail lending, lending in accounts outstanding of under 5 Billion Rps, accounts for a large proportion of Indonesian lending. Latest figures would indicate roughly 30% of all lending (and nonbusiness retail lending may account for another 10-20%). Business lending in amounts of 25 billion rps or less accounts for half of all lending. There are no accurate figures, but I think retail lending may account for over 40% of present outstandings, though this reflects the fact that the debts transferred to IBRA were disproportionately larger, and that the banks who are constrained from lending, except for some foreign banks lend disproportionately to larger borrowers. A large amount of traditional bank lending has moved off the books of Indonesian banks (abroad, into informal channels).[5] This includes some of the larger scale lending as well. There is in addition an impression that there is unmet lending potential for banks in the retail sector, though the evidence is mixed.[6]

Small Banks in Indonesia

On the supply side, the larger banks have not done a good job of lending. Many small banks (Class A) have. Even though they do not account for a large proportion of total assets, they account as noted above for a good proportion of good lending and one would expect that proportion to grow – unless the regulators prevent it. Some banks specialized in very small loans (Unit Desa, many BPR) have done quite well. These include a number of the smaller commercial banks. Recent banking regulations forestall the opening of new banks and there is some pressure, as in Malaysia, to push the big banks, all of which are presently controlled and owned by the government to consolidate into a number of giant banks.

World Experience -- Small Banks and Small Business

In very few countries are the largest banks the major lenders to smaller enterprises, except where they are state owned and have an explicit social thrust. Even though the larger chain banks in the US do considerable smaller scale lending – proportionally the smaller banks do a lot more. Every study indicates that the increasing role of larger banks in the US, in and of itself, leads to less small-scale credit. Even in the countries whose banking structure is dominated by large banks small scale lending is typically the specialty of second tier banks,

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[5] Shea, Francis X., "Indonesian Banking: Post-Recapitalization, Pre-Health and Safety," *Van Zorge Report on Indonesia* 3, 1, January 22, 2001, 5-23.

[6] Juda Agung et. al., "Credit Crunch di Indonesia Setelah Krisis: Fakta, Penyebab dan Implikasi Kebijakan, Jakarta: Bank Indonesia, March 2001.

cooperatives etc.[7] In those countries where licensed banks do not provide adequate services, a great deal of finance typically moves out of the banking system, and often out of the regulated sector. In the US, the development of the nonbank finance companies occurred because of things banks would not do, and it is only later that the banks bought up the major finance companies and used them as distribution channels for lending.[8]

The conclusion that consolidation in the American banking industry leads to less small business credit is not without controversy, particularly in the United States, which has seen a rapid increase in concentration in the banking industry. But the controversy is an issue of semantics. It appears that it is not size per se which is correlated with better and more small business lending but the level of competition at least in the United States. As a result of this competition even if larger merged banks reduce their small business lending proportionately, other lenders enter the market and take up the slack. But this in turn implies a relatively free entry into banking markets in which respect the United States is a rare exception. A recent FEDs Discussion paper from the Federal Reserve System deals with the observed effects of this consolidation. The study concludes that the institutions involved in mergers do reduce their small business lending, but that other lenders may expand their lending, market entry by

[7] In the United Kingdom, bank finance accounted for 47% of external funds in 1995-97, vs. 61% in 1997-1999, and 54 % in the United States. Twenty-five percent of the United Kingdom nonbank financing involved leasing. (Quarterly Report on Small Business Statistics, October 2001, London, Bank of England, n.d. Annex 2 External Finance, Source: ESRC Centre for Business Research, Cambridge, Chart 40, 41) (United States Small Business Administration, The Annual Report on Small Business and Competition 1998, Washington, D.C.: Government Printing Office, 1999, p. 164.)

For Europe as a whole, another source reported leasing and factoring accounted for 50% of all financing versus 49% in the United Kingdom, and external equity sources for another 11% of total finance. The earlier figures are based on numbers of firms, these presumably on volumes of finance (Ibid, Annex 3, Source: Grant Thornton Business Strategies -- European Business Survey, Spring 2001). In the United States, about half of all employees were in firms with under 500 employees. (http://www.census.gov/epcd/www/msallbus.html.)

In the United Kingdom as a whole, net borrowing by small business is quite low and both the industrial and banking structure quite concentrated. In the United Kingdom 44.9% of employees were in large firms versus 34.1% for Europe as a whole. (Small Business Small and Medium Enterprise Statistics for the United Kingdom (2000), Annex 3: UK Business Statistics Chart 37 and EIM Small Business Research and Consultancy, The European Observatory for Small and Medium Enterprise, Sixth Report 2000 in Bank of England, "Finance for Small Firms: An Eighth Report, March 2001, London: Bank of England, n.d., p. 12).

[8] Even today finance companies are a major source for small business lending -- and offer finance at prices comparable to and frequently lower than commercial banks. George W. Haynes, "Finance Companies and Small Business Borrowers, " http://www.sba.gov/advo/research/rs160.html. This is a 1995 study, but the proportion of such finance has not been falling. The current figures on small business lending in the United States are available in a report, *Small Business Lending in the United States,* issued each year.

others increases, and new entrants often use small business lending as their entrée.[9] Large banks do lend less proportionately to small business.[10] It is hypothesized that larger banks are unlikely to have the local knowledge to lend to small borrowers, though the advent of credit scoring and other mass market technologies obviously help them overcome this handicap.[11] But as the FEDS paper notices, there may also be the diversion of funds to the

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[9] Allen N. Burger, Lawrence G. Goldberg, and Lawrence J. White, "The Effects of Dynamic Changes in Bank Competition on the Supply of Small Business Credit," FEDS Discussion Paper No. 2001-35, http://papers.ssrn.com/sol3/paers.cfm?abstract_id=282513.

[10] Allen N. Berger, A.K. Kashyap, and J. M. Scalise, "The Transformation of the U.S. Banking Industry: What a Long, Strange Trip It's Been," Brookings Papers on Economic Activity II, 55-218, Washington, D.C.: Brookings Institution, 1995. Though one study, Berger and G. F. Udell, "Universal Banking and Small Business Lending," ed. A. Saunders and I. Walter, *Financial System Design: The Case for University Banking*, Burr Ridge, Il: Irwin, 1996, pp. 559-627 reports that they charge less and require less collateral -- perhaps indicating that they make fewer but higher quality loans. In reverse, small banks make higher profits on small business loans but take greater risks -- Robert Berney, James Kolari, and Charle Ou, "The Profitability of Small Business Lending by Small Banks," US Small Business Administration, Research Summary 184, April 1998. Not surprisingly another study, G. W. Haynes, C. Ou, and R. Berney, "Small Business Borrowing from Large and Small Banks," ed. Jackson L. Blanton, Alicia Williams, and Sherrie L. W. Rhine, *Business Access to Capital and Credit*, A Federal Reserve System Research Conference, 1999, pp. 287-327 not surprisingly reports that big banks' small clients are generally bigger, older, and more financially substantial. The large banks base their small business lending decisions more on quantitative analysis and less on the existence of a long term relationship -- R. A. Cole, L. G. Goldberg, and Lawrence J. White, "Cookie Cutter versus Character: The Micro Structure of Small Business Lending by Large and Small Banks, ed. Blanton, et.al. pp. 362-389. Full citations are in the FEDS paper but numerous articles show that when big banks are involved in mergers small business lending falls, when two small banks merge it increases -- but big banks, as the review notes, dominate merger activity.

Another source reports that "Commercial Banks with assets greater than One Billion Dollars control over half the markets for loans to small businesses. In 1995-2000, their market share grew from 54% to more than 60%. One-third of this gain came at the expense of midsize banks with assets of $100 million to $1 billion, whose market share dropped from 35% to 33% in the course of five years. Small banks with assets less the $100 million suffered the biggest loss in market share -- from 11% to 7%. Although larger banks dominate the small business market, in 2000 the share of small business loans in large banks' total business loan portfolio was less than 25% and declining. Small banks, however, remained heavily engaged in this market." (http://www.clev.frb.org/research/Et2001/0501/Html/commbank.htm) See also, "The Changing Banking Structure and Its Impact on Small Business: A Conference." Proceedings of a Conference sponsored by the United States Small Business Administration."

[11] "The advantage of small banks over large banks is, in a word, information. Credit scoring for small business loans turns the dynamic on its head." Ron Feldman, "Small Business Loans, Small Banks and a Big Change in Technology Called Credit Scoring," http://www.minneapolisfed.org/pubs/region/97-09/credit_score.html.

large corporate lending opportunities large banks enjoy, or simply the effects of disruption in the market because of management changes and bank reorganization.

In fact, the key U.S. conclusion seems to be that small business borrowers are benefited by active competition in their local credit markets, from whatever size bank it comes.[12] In reverse it is not so much the size of the large British banks, which has been faulted in recent reports, but their lack of competitiveness that increases the costs to small depositors.[13]

Generalizing from a United States example, especially in banking, is treacherous. With roughly 8,000 banks and thousands of credit unions (savings and loan cooperatives) the United States has so far had a relatively open and competitive banking structure. Most industrial countries have a far more limited financial structure. Germany has 3200 banks, France 1200, and the United Kingdom only 500.[14] But the bulk of these are small consumer or housing finance-oriented institutions.

The 603 German Sparkassen (Savings Banks) have 19,000 branches and 290,000 employees. They account for 40% of lending to the private sector, especially housing (half of all new homes) and credit cards (35 million cards).[15] Two thirds of all small business are among their customers. They are the major facilitator of German small business' international involvements. The larger number of smaller savings and loan cooperatives are also key sources for small business finance.

In Australia, there were 296 deposit taking financial institutions in 1999 -- 219 of them credit unions. There were 12 Australian owned banks, of which four owned 63% of the assets of all deposit taking financial institutions.[16]

The situation in developing countries is yet more complex -- because in so many cases the major banks are publicly owned. Not surprisingly the Philippines and South America frequently have structures similar to the United States. But even in Latin America small business is less frequently served by banks --and more frequently by nonbank financial institutions or the informal market.

In developing countries, where much activity is informal in any case, to avoid taxes and other financial demands from the powerful, and the benefits of formality in the collection of debts is much less important, a lot of small business lending moves out of the legal sector altogether. The history of the funding of real estate, smuggling, and the cinema in Mumbai is a classic example of well-developed, unsanctioned and usually illegal institutions. There have not been many studies of informal finance in Indonesia, partly because the authorities

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[12] Remarks by Governor Laurence H. Meyer, May 23, 1997 from http://www.federalreserve/gpv/boarddocs/speeches/1997/19970523.htm.

[13] Don Cruikshank, *Competition in UK Banking: A Report to the Chancellor of the Exchequer*, March 2000.

[14] http://specials.ft.com/ln/ftsurveys/industry/sc69ee.htm.

[15] http://www.germanembassy-india.org/news/dec97/gn06.htm.

[16] Marianne Gizycki and Philip Lowe, "The Australian Financial System in the 1990s,"

have resisted them -- but it is likely that similar phenomena exist. There is certainly material from the Dutch period that documents the Dutch authorities' struggle with informal financial forms.[17]

New Licensing Rules -- No New Banks and The Results

With the new licensing regulations requiring a minimum capital of three trillion Rps for a commercial bank and thus notionally an asset size of 30 billion, there will not be any new commercial banks in Indonesia in the near future. Some of the smaller banks like Buana, NISP, Mega etc. may develop but new bank entrepreneurship is over. The result will be that considerable focus will shift to finance companies, BPR, and even savings and loan cooperatives, to say nothing of informal forms of finance. This is in addition to the shift into informal and self-financing which has already occurred. The implications of this are varied. Indonesia has previously had a relatively small informal financial sector (at least for big people). It will grow. The regulatory and supervisory task for finance companies, savings and loan cooperatives, microfinance institutions, and BPR will become more severe. I predict that there will be considerable pressure to allow BPR to hold something like a current account, even if they do not have access to the payments system. Something of this sort is already occurring, as BPRs are the loci for commercial bank ATMs.

Implication

If there is a desire to avoid the informalization of Indonesian finance, it would seem desirable to discuss the scope for smaller scale, registered intermediaries which could meet some of the financing need in the retail and even commercial financing market.

[17] For example, Ida Yulianti, “Mindering di Pedesaan Jawa Pada Masa Awal Abad Ke-20 (1901-1920), Lembaran Sejarah II, No.. 1, 1999, pp. 1-30.